

*2011 Informational Series of Common Client Questions and Investor Education***Past Performance vs. Future Results of Investment/Asset Managers**

Back in the 1960's Sharpe (1966) and Jensen (1968) studies suggested that past performance of investment managers was not predictive of future results. Then in the 1990s-2000's there was an explosion of index<sup>1</sup> and index tracking exchange-traded funds.

More recently, however, research began to embrace the notion that active managers can add value for their investors. For instance, Brown and Goetzmann (1995) document that both superior and inferior performance tends to persist over consecutive one-year investment horizons. Further, several studies (e.g., Chen et al., 2000; Baker et al., 2005) show that managers possess significant stock-picking skills that translate into higher returns.

Alford et al. (2003) demonstrate that managers who exhibit more investment discipline produce higher returns. Specifically, they show that active managers who do a better job of controlling their tracking errors outperform both passive portfolios and other active managers with less risk-evaluating skill. Additionally, it showed that better-trained managers are also more likely to produce better performance.

Harlow and Brown in the *Journal of Investment Management* Vol 4 No 4 sought to extend the earlier studies by focusing on ways in which investors can select active managers with the best chance of producing superior subsequent investment returns. They focused not on just beating category averages, but on a risk-adjusted basis (using Alpha as excess return for risk taken). This is a criterion I have always used, combined with other factors in making my recommendations.

In the 26 page study, full of backtesting of performance and regression formulas<sup>2</sup>, it concluded:

1) The **average** active manager failed to produce positive risk-adjusted returns, net of fees, over an extended period of time.

2) However, a **substantial number** did produce positive alphas more consistently. The proportion of top performers varied widely by style (e.g., 33.97% for all portfolios, with a high of 48.86% for the small-cap growth style and a low of 24.74% for large-cap blend). Indeed, the rewards to the investor able to identify these managers were dramatic. The data showed the substantial benefit to investors who avoided the worst-performing managers.

3) The top performers were active managers who showed security selection and timing skills.

A June 2010 study by Jane Li<sup>3</sup> analyzed 31,991 U.S. actively managed investments representing over \$7 trillion of assets as of 2/28/2010, over 30 years of history. The study defined "**real alpha**" as "**additional return truly stemming from the unique ability and skill set of the investment manager.**" Using multi-factor regression models against 82 indexes, over 5 full market cycles, it tested a wide variety of variables. Results included: "**Previous Market Cycle Alpha:** the higher the alpha of the previous market cycle, the higher the alpha in the following market cycle."

In 2011 The Litman/Gregory management research group's research shows three factors that hinder consistent top performance which are also factors I take into consideration:

**Success results in asset growth.** Asset growth may lead to declining flexibility, especially for smaller-cap managers. Success often leads to stardom and the temptation to leverage the marketability of the portfolio management team by launching other

products. This may force the management team to manage other types of portfolios, reducing their focus on the original portfolio.

**Team turnover.** Success and "stardom" may lead the manager or key members of the team to move on to other firms/hedge funds, or start their own. If key players leave, the track record is basically worthless when evaluating the future opportunity.

**Overconfidence.** Great performance often leads to overconfidence that can result in analytical sloppiness and corners being cut, e.g., the manager may rely more on instinct or gut feel or mental short-cuts rather than doing all the difficult analytical work that contributed to past success.

I strongly agree with the Litman/Gregory conclusion which summarizes well my own views:

"The fact that track records are not predictive is not tantamount to concluding that top future performers can't be identified in advance. It simply means that the track record does not provide sufficient information to do so. Our approach to research recognizes that past performance is useful only as a tool for screening to identify those (managers) that may be worthy of further research. Value added comes from identifying why a manager performed well in the past, determining if the portfolio management team has an identifiable edge and assessing whether the edge (if one exists) is sustainable."

I also consider outside independent analyst reports such as those provided by Morningstar and other research organizations.

I have prepared a separate report on index/ETF vs. active management detailing the research on when and how active management has beat passive index investing.

**Summary** – *Markets will continue to be volatile based on daily events, yet some call the current equity market the timeliest in perhaps a generation for potential gains over the next few years.*

*Over the last 50-years (1961-2010), the unmanaged S&P500 index has had an average 9.7% total annual return. (Source BTN Research)*

*Although the outlook is good, there are market risks. I can recommend alternative opportunities without stock or most bond market exposure for more cautious investing, as well as more aggressive investment opportunities.*

**My Approach** - I do not recommend "dumb" index funds<sup>1</sup> or ETF's. Instead I recommend managers with long track records of outperformance (Alpha in Modern Portfolio Theory) vs. risk taken (Beta), among other important factors.

I continue to be proactive, suggesting changes as warranted, to take charge of investment opportunities.

As there are always market risks, I recommend "participate yet protect" strategies as much as possible, depending on individual investor objectives, investment time frame and risk tolerance.

**Invitation - Free Intro Meeting**  
**No cost or obligation sharing of ideas**

**We offer a "Portfolio X-Ray" of Your Current Holdings with Comparisons to our "Benchmarks" in Respective Sectors**

Past performance does not guarantee future results.

<sup>1</sup> Investors cannot directly invest in indices

<sup>2</sup> A regression is a statistical measure to determine the strength of a relationship between variables.

<sup>3</sup> When Active Management Shines vs. Passive - Examining Real Alpha in 5 full market cycles over the past 30 years Extensive Report by Jane Li, CFA June 2010.

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